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ONE ARTICLE FROM OER'S ECONOMIC INTELLIGENCE WEEKLY REVIEW DATING 23 FEBRUARY 1978. REQUEST ARTICLE BE PASSED TO AMBASSADOR, DCM, ECONOMIC SECTION AND OTHER WORKING LEVEL STATE OFFICERS.

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BRAZIL: BALANCING ECONOMIC GOALS.

1. POLITICKING FOR THE OCTOBER CONGRESSIONAL ELECTIONS WILL LIKELY INDUCE THE MILITARY REGIME OF PRESIDENT ERNESTO GEISEL TO ALLOW SOME SLIPPAGE IN BRAZILIAN STABILIZATION TARGETS. NONETHELESS, SATISFACTORY ECONOMIC GROWTH OF 5 TO 6 PERCENT SHOULD BE OBTAINABLE IN 1978 WITHOUT JEOPARDIZING RECENT GAINS ON THE CURRENT ACCOUNT AND INFLATION FRONTS.

2. LAST YEAR, STRONG EXPORT PERFORMANCE AND A GOOD HARVEST GREATLY AIDED BRAZIL IN BALANCING CONFLICTING ECONOMIC OBJECTIVES. AUSTERITY MEASURES COUPLED WITH EXPANDED EXPORTS SHARPLY REDUCED THE CURRENT ACCOUNT DEFICIT FOR THE FIRST TIME SINCE THE 1973/74 OIL PRICE HIKES AND TRIMMED INFLATION WITHOUT UNDULY CUTTING OUTPUT AND JOBS.

ACCUMULATING PROBLEMS, 1974-76.

3. BECAUSE OF BRAZIL'S HEAVY DEPENDENCE ON FOREIGN ENERGY, ITS PAYMENTS POSITION WAS HARD HIT BY THE QUADRUPLING OF OIL PRICES IN 1973/74. RELUCTANT TO DISTURB ITS FRAGILE POLITICAL SUPPORT BY DRASTIC AUSTERITY POLICIES, THE GEISEL REGIME ATTEMPTED TO MAINTAIN SUBSTANTIAL ECONOMIC GROWTH, IMPOSING ONLY ENOUGH "STOP AND GO"

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MEASURES TO PREVENT FURTHER CURRENT ACCOUNT DETERIORATION. THE CONSEQUENCES DURING 1974-76 WERE:

REAL GDP GROWTH, ALTHOUGH SUFFERING PRONOUNCED YEAR-TO-YEAR FLUCTUATIONS, AVERAGED 8 PERCENT ANNUALLY.

THE INFLATION RATE DOUBLED, REACHING 46 PERCENT BY 1976.

THE CURRENT ACCOUNT DEFICIT SOARED FROM \$1.7 BILLION TO ABOUT \$6 BILLION TO \$7 BILLION.

HEAVY BORROWING ABROAD INCREASED FOREIGN DEBT AT UNSUSTAINABLE RATES AND BEGAN TO RAISE DOUBTS ABOUT BRAZIL'S CREDITWORTHINESS BY YEAREND 1976.

4. AFTER THE INITIAL HUGE JUMP IN 1974, THE CURRENT ACCOUNT DEFICIT WAS KEPT FROM FURTHER DETERIORATION BY A MODERATE EXPANSION OF EXPORTS AND BY RESTRICTIONS THAT HELD IMPORTS CLOSE TO THE 1974 LEVEL. THE RESULT WAS A SUBSTANTIAL DECLINE IN THE TRADE DEFICIT, ALTHOUGH THE BENEFITS TO THE CURRENT ACCOUNT WERE LARGELY OFFSET BY THE RISE OF INTEREST PAYMENTS ON THE SOARING FOREIGN DEBT. FOREIGN CAPITAL INFLOWS PREVENTED A SERIOUS DECLINE IN BRAZIL'S INTERNATIONAL RESERVES.

5. BRAZIL WAS ABLE TO MAINTAIN ECONOMIC GROWTH DESPITE IMPORT CONSTRAINT THROUGH (A) GENERALLY GOOD AGRICULTURAL PERFORMANCE AND (B) DRAWDOWNS OF LARGE INVENTORIES OF IMPORTED INDUSTRIAL SUPPLIES AND EQUIPMENT ACCUMULATED IN 1974-76. ADDITIONAL HELP CAME FROM AN ACCELERATED IMPORT SUBSTITUTION PROGRAM. ALTHOUGH THE GREATEST BENEFITS ARE STILL TO COME, THE PROGRAM HELPED RAISE THE SHARE OF DOMESTIC EQUIPMENT USED IN MAJOR INVESTMENT PROJECTS FROM 53 PERCENT IN 1973 TO 68 PERCENT IN 1976. THE COST WAS MOUNTING INFLATION, ATTRIBUTABLE BOTH TO SUPPLY SHORTAGES AND HIGHER COSTS OF USING DOMESTIC SUBSTITUTES.

MOVEMENT TOWARD EQUILIBRIUM IN 1977.

6. ALTHOUGH BRASILIA BEGAN TO IMPLEMENT SERIOUS AUSTERITY MEASURES IN 1976 TO REDUCE THE CURRENT ACCOUNT DEFICIT AND SLOW INFLATION, ADJUSTMENT LAGS AND DEFICIENCIES IN MONETARY CONTROLS KEPT AUSTERITY FROM TAKING HOLD UNTIL 1977. A KEY NEW ELEMENT WAS A SHARP CUTBACK IN

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PUBLIC INVESTMENT SPENDING, UNDER WHICH OUTLAYS PROGRAMED FOR 1977 IN THE SECOND DEVELOPMENT PLAN WERE CUT BY 25 PERCENT. ELECTRIC POWER, COMMUNICATIONS, AND RAIL AND PORT CONSTRUCTION WERE MOST AFFECTED, AND ONLY VITAL IMPORT SUBSTITUTION PROJECTS WERE SPARED, NOTABLY IN PETROLEUM. FURTHER RESTRAINT WAS IMPOSED BY KEEPING WAGE ADJUSTMENTS BEHIND INFLATION; THE RESULT WAS A 2- TO 3-PERCENT CUT IN REAL WAGES, WHICH HELPED TO EASE THE IMPACT OF AUSTERITY ON EMPLOYMENT. WHILE THE LOSS IN REAL WAGES STIMULATED VOCAL OPPOSITION FROM THE MORE RADICAL UNIONS, SUCH AS THE METALWORKERS, IT WAS GENERALLY ACCEPTED WITH RESIGNATION.

INFLATION MODERATES.

7. PARTLY BECAUSE THE ANNUAL ADJUSTMENT OF CONTROLLED PRICES TAKES PLACE IN THE EARLY MONTHS OF EACH YEAR, AUSTERITY MEASURES DID NOT BEGIN TO SHOW FAVORABLE RESULTS UNTIL MIDYEAR 1977. AVERAGE MONTHLY INFLATION, WHICH HIT OVER 50 PERCENT (ANNUAL RATE) DURING THE FIRST SIX MONTHS, WAS CUT IN HALF IN THE THIRD QUARTER, ALTHOUGH INFLATION PICKED UP IN THE NORMALLY EXPANSIONARY FOURTH QUARTER, THE RATE FOR THE YEAR WAS HELD TO 39 PERCENT, COMPARED WITH 46 PERCENT IN 1976.

8. A GREATER REDUCTION IN INFLATION WAS PRECLUDED BY BRAZIL'S INABILITY TO STICK TO ITS MONETARY GOALS; THE MONEY SUPPLY GREW BY 38 PERCENT, COMPARED WITH THE GOVERNMENT'S ORIGINAL 25-PERCENT TARGET. THE DIFFICULTIES IN MEETING THE TARGET STEMMED FROM (A) THE NEED TO FINANCE RISING COFFEE STOCKS FOLLOWING THE JULY CESSATION OF COFFEE EXPORTS; (B) THE STRONGER THAN EXPECTED PERFORMANCE OF AGRICULTURE, WHICH REQUIRED ADDITIONAL CREDIT TO FINANCE STOCKPILING UNDER THE PRICE SUPPORT PROGRAM; AND (C) THE LARGE SALE OF BONDS BY STATE-OWNED ENTERPRISES IN SEPTEMBER. THE GOVERNMENT MOVED TO TIGHTEN DRASTICALLY MONETARY RESTRICTIONS IN SEPTEMBER THROUGH CREDIT CEILINGS, INCREASES IN THE REDISCOUNT RATE AND IN RESERVE REQUIREMENTS FOR COMMERCIAL BANKS, AND THE TEMPORARY STERILIZATION OF THE PROCEEDS OF EXTERNAL LOANS.

IMPACT ON ECONOMIC GROWTH.

9. ALTHOUGH AUSTERITY CAUSED A MARKED SLOWING OF ECONOMIC ACTIVITY, REAL GDP STILL GREW BY A RESPECTABLE 4.7 PERCENT IN 1977, ALMOST ENOUGH TO ABSORB THE INCREMENT

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IN THE LABOR FORCE. AGRICULTURE WAS THE STAR PERFORMER, WITH OUTPUT ADVANCING 10 PERCENT BECAUSE OF A GOOD GROWING SEASON AND THE RECOVERY OF COFFEE PRODUCTION. INDUSTRIAL PRODUCTION ROSE 3 PERCENT, REFLECTING THE COMPLETION OF IMPORT SUBSTITUTION PROJECTS IN PETROCHEMICALS AND STEEL AND THE STRONG GROWTH OF FOOD PROCESSING. OTHER MANUFACTURING, HOBBOLED BY AUSTERITY MEASURES, GAINED UNDER 2 PERCENT IN THE FIRST HALF AND EVEN LESS IN THE SECOND. CONSUMER-ORIENTED INDUSTRIES WERE THE HARDEST HIT. AUTOMOBILE PRODUCTION, PREVIOUSLY THE PRINCIPAL ENGINE OF INDUSTRIAL GROWTH, SUFFERED ITS FIRST DECLINE--ALMOST 7 PERCENT.

FAVORABLE FOREIGN SECTOR PERFORMANCE.

10. INCREASED EXPORTS WERE LARGELY RESPONSIBLE FOR THE SUBSTANTIAL IMPROVEMENT IN BRAZIL'S CURRENT ACCOUNT IN 1977. COFFEE AND SOYBEAN EXPORTS WERE UP 25 PERCENT AND 17 PERCENT THROUGH NOVEMBER. MANUFACTURES--BENEFITING FROM DEVALUATIONS TOTALING 30 PERCENT, EXPORT INCENTIVES, AND WEAK DOMESTIC DEMAND--REGISTERED THE LARGEST GAIN, INCREASING BY ALMOST 40 PERCENT. WEAKENED DEMAND AND DIRECT CONTROLS CONTINUED TO LIMIT IMPORTS. THE TRADE BALANCE WAS TURNED AROUND, FROM A \$2.1 BILLION DEFICIT IN 1976 TO A SURPLUS OF \$123 MILLION.

11. THE STRONG TRADE PERFORMANCE BROUGHT A SUBSTANTIAL IMPROVEMENT IN BRAZIL'S CURRENT ACCOUNT, CUTTING THE DEFICIT FROM \$6.1 BILLION IN 1976 TO \$3.8 BILLION IN 1977. CAPITAL INFLOWS MORE THAN OFFSET THE DEFICIT, AND OFFICIAL RESERVES INCREASED BY \$700 MILLION, TO \$7.2 BILLION. TOTAL FOREIGN DEBT INCREASED FROM \$26 BILLION AT YEAREND 1976 TO \$31 BILLION AT YEAREND 1977. SERVICING OF THE FOREIGN DEBT EQUALED 46 PERCENT OF MERCHANDISE EXPORTS IN 1977, DOWN FROM 48 PERCENT IN 1976.

OUTLOOK FOR 1978.

12. DESPITE PROGRESS ON BOTH THE INFLATION AND PAYMENTS FRONTS IN 1977, MAJOR PROBLEMS REMAIN. THE CONTINUING NEED TO CONTROL THE CURRENT ACCOUNT DEFICIT AND PRESERVE BRAZIL'S INTERNATIONAL CREDIT RATING CONFLICTS WITH THE POLITICAL NECESSITY OF MAINTAINING REAL WAGES AND ENSURING THE 6-PERCENT GROWTH REQUIRED TO KEEP UNEMPLOYMENT FROM RISING.

13. RECENT STATEMENTS BY PRESIDENT GEISEL AND MINISTER

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OF FINANCE SIMONSEN INDICATE THAT THE LEADERSHIP INTENDS TO CONTINUE ITS EMPHASIS ON REDUCING INFLATION AND CUTTING THE CURRENT ACCOUNT DEFICIT. EVEN SO, ELECTION YEAR POLITICS AND THE ADMINISTRATION'S DESIRE TO COMPLETE MAJOR IMPORT SUBSTITUTION PROJECTS BEFORE LEAVING OFFICE IN MARCH 1979 WILL LIKELY FORCE A LOOSENING OF OFFICIAL MONETARY AND FISCAL TARGETS. PRESIDENT GEISEL KNOWS HIS EFFORTS TO LIBERALIZE THE BRAZILIAN POLITICAL SCENE GRADUALLY (THROUGH LESS CENSORSHIP AND REPRESSION) COULD EASILY BACKFIRE IN A YEAR OF POLITICAL TRANSITION IF THE DOMESTIC ECONOMY BECOMES A FOCAL POINT FOR OPPOSITION CRITICISM.

GROWTH AND INFLATION.

14. THE CONFLICT BETWEEN AUSTERITY AND THE POLITICS OF TRANSITION WILL ALMOST CERTAINLY PRECLUDE ATTAINMENT OF THE TARGET OF LESS THAN 30-PERCENT INFLATION IN 1978. REAL PUBLIC SECTOR SPENDING IS BUDGETED AT ALMOST LAST YEAR'S LEVEL BUT PROBABLY WILL BE CONSIDERABLY HIGHER AS A RESULT OF OVERSPENDING BY GOVERNMENT-OWNED COMPANIES. EVEN THOUGH FINANCE MINISTER SIMONSEN HAS RECENTLY GAINED ADDITIONAL AUTHORITY TO CONTROL PUBLIC SPENDING, HE WILL HAVE DIFFICULTY FOLLOWING THROUGH IN AN ELECTION YEAR. THE GOVERNMENT'S MAIN TOOL TO CONTROL INFLATION IN 1978 THUS WILL ONCE AGAIN BE MONETARY POLICY. MUCH BETTER CONTROL OVER MONETARY EXPANSION THAN IN THE PAST WILL BE REQUIRED IF THE GOVERNMENT HOPES TO HOLD INFLATION UNDER 35 PERCENT.

15. WITH THE EASING OF AUSTERITY, BRAZIL SHOULD BE ABLE TO OBTAIN POLITICALLY ACCEPTABLE REAL ECONOMIC GROWTH OF 5 TO 6 PERCENT. AGRICULTURE, WHILE NOT EXPECTED TO MATCH LAST YEAR'S SOLID PERFORMANCE, SHOULD STILL POST SUBSTANTIAL GAINS, MAINLY AS A RESULT OF AN EXPECTED 20-PERCENT RISE IN THE COFFEE CROP. THE INCREASE IN INDUSTRIAL PRODUCTION SHOULD TOP LAST YEAR'S 3 PERCENT AS GOVERNMENT AND PRIVATE INVESTMENT PROGRAMS ARE STEPPED UP AND AS MAJOR PROJECTS COME ON LINE. THE NATIONAL DEVELOPMENT BANK PLANS TO EXPAND PRIVATE SECTOR LOANS BY 10 TO 15 PERCENT IN REAL TERMS, AND THE CONSOLIDATED INVESTMENT BUDGETS OF PETROBRAS, SIDERBRAS (NATIONAL STEEL COMPANY), AND OTHER BASIC INPUT COMPANIES RUN 20 TO 25 PERCENT ABOVE 1977 IN REAL TERMS. STEEL AND PETROCHEMICAL PRODUCTION SHOULD CONTINUE TO POST GOOD GAINS ON THE BASIS OF EXPANDED CAPACITY. CONSUMER INDUSTRIES, ESPECIALLY AUTOMOTIVE FIRMS, PROBABLY WILL REBOUND IN 1978.

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TRADE AND PAYMENTS.

16. DESPITE SLOWER GROWTH OF EXPORTS, BRAZIL'S TRADE BALANCE SHOULD SHOW A SLIGHT IMPROVEMENT THIS YEAR. EXPORTS ARE EXPECTED TO INCREASE 10 PERCENT IN VALUE, EVEN THOUGH AGRICULTURAL EXPORTS PROBABLY WILL REMAIN AT THE 1977 RECORD LEVEL, WITH VOLUME INCREASES OFFSETTING AN EXPECTED DROP IN PRICES. EXPORTS OF MANUFACTURED AND SEMIMANUFACTURED GOODS THUS WILL AGAIN LEAD THE WAY, INCREASING BY AROUND 25 PERCENT IF--AS EXPECTED--THE CRUZEIRO CONTINUES TO BE DEVALUED IN LINE WITH INFLATION.

17. AFTER THREE YEARS OF PRACTICALLY NO GROWTH, IMPORT VOLUME WILL HAVE TO INCREASE THIS YEAR TO SUPPORT ECONOMIC EXPANSION AND TO HELP DAMPEN INFLATIONARY PRESSURES. A MAJOR DETERMINANT OF BRAZIL'S SUCCESS IN RESTRAINING IMPORTS WILL BE THE TIMING OF COMPLETION OF SEVERAL LARGE STEEL, CHEMICAL, AND FERTILIZER PROJECTS, WHOSE OUTPUT WILL SUBSTITUTE FOR IMPORTS. EVEN ALLOWING FOR SUBSTANTIAL SUBSTITUTION, BRAZIL HARDLY WILL BE ABLE TO HOLD IMPORTS UNDER \$13 BILLION, COMPARED WITH \$12 BILLION LAST YEAR.

18. BRAZIL'S CURRENT ACCOUNT IS LIKELY TO DETERIORATE SLIGHTLY THIS YEAR. THE SMALL IMPROVEMENT IN THE TRADE BALANCE WILL NOT OFFSET A DETERIORATION IN THE SERVICES ACCOUNT, AS INTEREST PAYMENTS ON FOREIGN DEBT INCREASE BY APPROXIMATELY \$500 MILLION. BRAZIL SHOULD HAVE LITTLE TROUBLE HANDLING ITS ANTICIPATED \$4 BILLION CURRENT ACCOUNT DEFICIT. DIRECT FOREIGN INVESTMENT INFLOWS SHOULD CONTINUE TO COVER \$1 BILLION OF THE DEFICIT, AND A \$3 BILLION INCREASE IN BRAZIL'S FOREIGN DEBT SHOULD BE READILY ARRANGED. THE INTERNATIONAL BANKING COMMUNITY PROBABLY WOULD BALK AT PROVIDING FUNDS MUCH IN EXCESS OF THIS FIGURE, GIVEN ITS ALREADY LARGE EXPOSURE IN BRAZIL. BRAZILIAN BORROWING RATES ARE NOW AVERAGING 2 PERCENTAGE POINTS ABOVE THE LONDON INTERBANK RATE. (CONFIDENTIAL) E1,2,3 IMPDET WNINTEL.>
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